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Technical Report

Some Implications of the Recent Burst in Mutual Funds in Indonesia

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Some Implications of the Recent Burst in Mutual Funds in Indonesia

Background

Mutual funds (reksadana) were first introduced into Indonesia in 1996, but they were a minor financial instrument through 2001. Business began to boom in 2002,[2] when mobilized funds soared from less than Rp 8 trillion at end-2001 to almost Rp 60 trillion in early 2003. As of March 2003, there were 145 reksadana offering 4 types of products: fixed income, money markets; equity; and balanced (i.e. mixed). Sales agents included 12 banks (6 foreign and 6 private). As of October 2002, banks acting as fund agents had mobilized around 60% of total reksadana with the bulk of the funds in fixed income assets (mainly government bonds). Among the banks, Citibank, Danamon, BCA and Panin have been leaders in the field and Bank Mandiri, BRI and Bank Permata have recently indicated interest in offering the product.

As of March 2003, financing mobilized by reksadana showed no signs of leveling off. Indeed, if Bank Mandiri and BRI enter this field aggressively, amounts will continue to climb, probably exceeding Rp100 trillion (equivalent to approximately 80% of base money or 11% of M2) within another 12 months or so. The pace of this expansion and links to the still weak banking sector have raised certain concerns that are discussed below.[3]

How Does it Work?

Reksadana agents (which are called 'investment managers' and which may be a bank subsidiary) mobilize financing that is used to buy financial assets. The investment manager buys and sells financial assets, the range of which is limited by the fund's charter (called a collective investment contract).[4] As just mentioned, a fund may specialize in one of four broad types of financial assets; the great bulk (over 80% as of March 2003) is fixed income, i.e., corporate and government bonds. Because the yield on bonds is substantially higher than on time and savings deposits (12 to 15% versus around 11%), significant funds have been shifting from the latter into the former. More importantly, investors' income from reksadana is fully exempt from tax for 5 years under Tax Law No. 17/2000.[5] Income flows into the reksadana are subject to the following exemptions and taxes:

- Coupon income from bonds is exempt from the normal 20% withholding tax;

[2] It appears that Citibank originated banks' acting as sales agents in 2000. Danamon introduced the innovation of selling their recap bonds to its associated fund and BCA followed suit to defend its customer base.

[3] Some Reksadana have been offering guaranteed rates of return, but these seem limited to those funds that hold fixed rate government bonds. Currently, the main issue in this regard is one of consumer protection. Namely, that some sales promotions by reksadana give the impression that the product is guaranteed or covered by the government's bank guarantee. Indeed, at least one bank has issued certificates in the regard.

[4] The other major player is the 'custodian', who administers the cash transactions and does the reporting.

[5] In principal, the tax exemption would end in 5 years. In practice as the 5-year sunset approached, the funds would probably be re-cycled into a new fund that would be eligible for another 5-year exemption.

- Interest income from SBIs and time deposits is subject to a 20% withholding tax;
- Equity is subject to 0.1% of equity sold; and,
- Bonds are subject to a 30% tax on capital gains.

The tax exemption for coupons on bonds is particularly notable because interest on time and savings deposits is subject to a 20% withholding tax. Consequently, the *after-tax* rate of return on bank deposits is only about 9%, way below the 12-15% on fixed income reksadana. Moreover, the ceiling on holdings of long-term debt instruments (of maturity >3 years, but essentially government securities) is high (80%);[6] the remaining 20% is usually SBIs, time deposits and cash.

From the side of the banks, this is good business. First, it allows them to liquidate some of their holdings of government bonds. Second, the mutual fund's liability does not have a central bank reserve requirement; by contrast, the bank had to hold a 5% reserve requirement when the liability was a bank time deposit. And third, the bank earns fee income on transactions, of 1½% for subscription and 1½% for redemption; both appear to be negotiable.[7] Other fees (which are not negotiable) comprise:

- A Fund Manager's fee of 1 to 1 ½% per annum;
- A Custodian fee of up to 25 bps per annum; and
- Normal brokering fees, for buying and selling assets.

On a few other technical details, redemptions normally have a 4-day settlement period (compared with 3 for the JSX), but there is provision for up to 7 days.[8] Unit prices (or Net Asset Values, NAVs) are calculated on a daily basis, which poses something of a problem in valuing illiquid assets like some government bonds. Responsibility for resolving this problem lies with the fund manager. Income payments (i.e. dividends) from the Fund are normally re-invested in the Fund, but usually provision can be made for regular payments directly to the client.

Supervision of Indonesia's mutual funds reflects Bapepam's general philosophy of emphasizing disclosure and self-regulation. For example, a reksadana's prospectus contains a great deal of information about its operation; inspections focus on compliance with this prospectus; the custodian is expected to report rule violations to Bapepam;[9] and paid-up capital of investment managers is being raised significantly.[10] Beyond this, companies' monthly reports are the primary monitoring device; in normal circumstances, these are supported by on-site

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6 There are notable limits on other holdings of financial instruments. For example, reksadana cannot invest in derivatives; non-government securities in any one corporation are limited to 5-10% (depending upon the mutual fund) of the total portfolio; and holdings of foreign securities are limited to listed companies and to 15% of the portfolio.

7 All fees are to be disclosed in the fund's prospectus.

8 The provision for extra days appears to be intended to provide fund managers some flexibility in liquidating assets.

9 Custodian banks include some well-known names. For example, Deutsche Bank; Citibank; ABN-AMRO; Bank Niaga; and Bank Mandiri. Some of these, for example, Deutsche Bank, have a reputation for being quite strict.

10 Prior to 1999/2000, minimum paid-up capital was only Rp500,000,000. In that year it was raised to Rp 2 billion for new licenses, and to Rp 5 billion in May 2003. For existing licenses, the schedule is more extended, to Rp2.5 billion by December 2003; to Rp3 billion by December 2004; and to Rp 5 billion by end-2005.

inspections targeted at once every 2 years.[11] For large companies, inspections focus on internal controls and sampling the investment manager's portfolio management. Companies with small amounts of funds may be closed.[12]

Concerning the important issue of liquidity management, investment managers are expected to manage their portfolios in a way that allows them to redeem up to 20% of the portfolio in one day.[13] In practice, Fund Managers appear to have a great deal of discretion in this regard.

It is widely believed that the boom in reksadana has been financed by declines in the time & savings deposit component of M2.[14] Also, because some of these funds originated abroad, inflows into these reksadana have been a factor behind the recent appreciation of the rupiah.

The Benefits

For some time, the development of reksadana has been an objective of financial sector development in Indonesia. From this point of view, the diversified nature of reksadana provides a more stable form of financing than, say, investment in the stock market. Ideally, reksadana would attract new financing into Indonesia. However, the expansion appears to have mainly shifted the composition of financial assets from time deposits into mutual funds, at a substantial fiscal cost to government. Effectively, the boom in reksadana has partly been an artificial product of the tax exemption.[15]

To date, the growth of reksadana has benefited the financial system. In particular, it has shifted ownership of government recap bonds from banks to private hands (the holders on the reksadana). This is helpful because it spreads the ownership of government bonds, thereby deepening the market for trading. Also, the expansion of reksadana has increased the demand for corporate bonds, which is a healthy diversification of corporate financing away from its traditional reliance on banks.

In addition, because banks' ownership of recap bonds (their assets) has been accompanied by a decline in time and savings deposits (the banks' liabilities), the migration of

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11 In practice, this seems to be a difficult target to hit. By contrast, the Jakarta Stock Exchange inspects once a year.

12 In total, four Funds were closed in 2002. There have been suggestions that these Funds were closed because of the 5-year sunset clause.

13 The managers are not allowed to maintain lines of credit, for example with parent banks.

14 However, many analysts believe that some of the funds originated abroad, which makes the analytics more complicated. For example, under a truly floating exchange rate regime, an inflow of foreign funds would cause the rupiah to appreciate, but leave total rupiah money supply unchanged. In this case, domestic sources of financing are less clear, but they are probably mainly accounted for by declines in holdings of the closest substitute, namely time and savings deposits. By contrast, if Bank Indonesia intervenes in the foreign exchange market without sterilization (or if the rupiah were on a fixed exchange rate regime), the capital inflows into reksadana would create new base money. In current circumstances, where BI is intervening with sterilization, the floating exchange rate regime model is more appropriate.

15 Other factors included the issuance of major amounts of government recap bonds; the recent popularity of corporate bonds; and the decline in short-term instruments.

time & savings deposits into reksadana has served to shrink bank's balance sheets to a more realistic statement of their financial size.

It's odd that another benefit has *not* emerged recently, namely an extension of the maturity on banks' time deposits. The great bulk of time deposits are still at the 1- and 3-month maturities. At longer maturities, there are only bonds, although these do cover the maturity spectrum from a few months out to about 20 years.

And the Risks

Some significant risks are emerging in line with this expansion of Mutual Funds. On the macro side, capital inflows (of either foreign money or repatriated Indonesian assets) are causing the exchange rate to appreciate and interest rates to drop; dealing with this problem is proving complicated, as discussed in a separate note.

Also, there are serious prudential risks associated with this rapid expansion of reksadana. For example, if there were to be a run on these reksadana (due to, say, a reversal of the capital inflows), the fund manager would be obliged to sell significant amounts of bonds into a market that is still very thin.[16] If this were to happen, the prices of bonds would plunge; long-term interest rates would climb steeply; and recap banks' CARs would drop (because of marked-to-market requirements in their remaining holdings of bonds).

Liquidity problems in the reksadana industry could feedback into the banking system. For instance, banks may have hidden contingent liabilities to their associated reksadana,[17] which would effectively transfer the mutual fund's risk back to the bank. Also, the public appears to be unclear as to whether the government's blanket guarantee covers this financial instrument. Even without a guarantee or one form or another, a sponsoring bank may feel obliged to stand behind its reksadana, which heightens liquidity risk for banks.

Rules appear weak and enforcement lax in some areas, as regulators struggle to catch up with the surge in reksadana.[18] By way of a few examples, some banks appear to be acting as custodian for their own reksadana, despite rules to the contrary. Also, there are few rules regarding conflict of interest in the operation of reksadana. Along similar lines, custodians have a responsibility to report violations of rules, but this is weakened by allowed flexibility in implementation of policies. Furthermore, daily valuations are difficult for securities that are not listed on any exchange, and these constitute the bulk of assets in these funds. Moreover, there is evidence of transactions between reksadana and their sponsoring bank at prices that do not reflect market valuation. By way of a few examples of the potential for abuse without very tight supervision:

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16 In a typical month, market players say that roughly Rp 15 trillion of bonds are currently traded.

17 Banks indicate that there are no official guarantees or buy-back arrangements.

18 For example, there are approximately 60 Fund Managers and 10 Bapepam staff. A typical on-site inspection takes about 2 weeks.

- There is opportunity for collusion between the Fund Manager and the parent bank, for example in transfer pricing of financial instruments;
- Likewise, there are opportunities for side agreements between the Fund Manager and the Custodian;
- The 7-day settlement period provides ample opportunity for slight of hand; and
- The pricing of illiquid instruments allows room for creative accounting.

Finally, the fiscal cost of subsidizing reksadana is getting large. At present, the tax loss of the exemption is estimated at Rp 1½ trillion *per annum.* This amount could double if Bank Mandiri and BRI enter the market in an aggressive way. The distributional effect of this subsidy is also notable as the great bulk of tax losses accrue to wealthy, relatively sophisticated investors. The poor have no savings and pay no taxes.

Implications for Policy

As just mentioned, there are prudential risks in these reksadana; the risks are likely to rise as regulators rush catch up with the rapid pace of expansion; and the amounts are becoming large enough to constitute a systemic risk. In response, Bapepam regulators should become more pro-active in its supervision, at least as regards those funds that have formal or informal ties into the banking system.

As mentioned, reksadana receive a significant tax exemption. This exemption was introduced to provide a monetary incentive for the development of mutual funds as an alternative source of relatively stable financing. This goal has now been achieved as witnessed by the 2002 burst in mutual funds; it is now time to back off this incentive and level the financial playing field before the distortionary effects generate more problems than they solve. To slow the expansion of reksadana (and capital inflows), it would be most helpful to eliminate the tax exemption; at a minimum, it should be cut significantly.

Bank Indonesia also has a role to play in this field, because some of the reksadana may represent an off-balance sheet liability for banks. Strict limits need to be placed on banks' contingent liabilities in this area, particularly as concerns back-back arrangements for recap bonds in the event of run on the mutual fund.

The emergence of reksadana has caused a sizable downward shift in the demand for money, which has implications for monetary policy. As noted earlier, the closest substitute for reksadana is time deposits. Consequently, this new financial asset will have caused a shift away from the demand for M2 into some broader, unmeasured demand for money, say M3. This shift is significant, of the order of Rp 50 trillion, or 6% of M2 in roughly one year. While the underlying relationship between this M3 and GDP is probably unchanged, the ratio of M2 to GDP will have declined. This accounts in part for the relatively slow growth of M2 during the past year.[19]

[19] M2 has been decelerating sharply since early 2001, and its growth has generally been negative in real terms since early 2002. As of February 2003, it was up 7.6% relative to a year earlier.

This shift in M2 has implications for the conduct of monetary policy, because the downward shift in demand for M2 implies a downward shift in the demand for base money (reserves of 5% must be held against time & savings deposits). This shift is of the order of Rp 2 1/2 trillion (that is, 5% of Rp 50 trillion), which is equivalent to roughly 2% of average base money (M0) in 2002. This is a moderate shift that accounts for perhaps 1/3 of the current gap between M0 and Bank Indonesia's target for M0.[20]

Recommendations

Several steps could be taken to bring the growth in mutual funds under control. These include, in order of likely impact:

i) At an early date, begin discussions with Parliament on eliminating the tax exemption for reksadana, preferably for the August 2003 Budget

ii) Strengthen aspects of direct supervision: a) of reksadana by Bapepam, especially as regards liquidity risk and including the provision of specialized TA to Bapepam; b) of banks sponsoring reksadana by Bank Indonesia, especially of transactions that do not appear to reflect market pricing; and c) of pension funds, that may be over-investing in risky, illiquid assets.

iii) As an educational device: re-iterate that banks' liabilities to reksadana are not covered by the blanket guarantee; and use every opportunity to remind fund holders (including fund managers of pension funds) that these instruments are not liquid.

iv) Improve coordination between BI and Bapepam: regarding bank-sponsored reksadana. As an important by-product, this would provide an opportunity to assess the likelihood that OJK will be a success.

[20] This shift is not important enough to motivate an adjustment to BI's targets for 2003. However, it should be kept in mind in assessing the current stance of monetary policy. Also, if the growth of reksadana continues into 2004, a continuing shift should be taken into account in setting the M0 target for that year. BI staff need to research this issue in more detail; for example, there is no mention of this phenomenon in BI's discussion of mutual fund issues in its Annual Report for 2002 (See Box, page 80-81).